Internal Revenue Service
memorandum

date: September 6, 1991

to: Elmer Kletke
Regional Commissioner
Midwest Region

from: Assistant Chief Counsel, Passthroughs and Special Industries
National Office

subject: BEE-12 Forms Simplification Phase Group Reports

This memorandum is in response to an invitation to comment on a phase group report recommending changes to Form 1065, U.S. Partnership Return of Income, and its instructions. The following are the issues which we thought required comment or recommendations:

ISSUES

First, we support your proposal to change the reporting date for partnerships to the 15th day of the third month of the following taxable year (March 15th in most cases). As your report pointed out, this would insure that the individual partners received their K-1's in time to prepare their personal returns before the April 15th filing deadline. Under current law, partnerships do not have to furnish their partners with K-1's until the due date for the partnership's return. Section 6031 of the Internal Revenue Code. This must inevitably result in many partners being forced to request extensions of the time to file.

Second, we applaud the introduction of a table of contents and an index to the instructions.

Third, we agree with your proposal to begin offering the use of a simplified Form 1065EZ and a simplified Form K/K-1EZ. Furthermore, your criteria for classifying those partnerships which will be allowed to use the simplified forms seem sensible. We suggest, however, that the simplified forms and their instructions be modified to adopt certain suggestions outlined below.

Fourth, we disagree with the deletion of Question R. The Passthroughs and Special Industries division of Chief Counsel uses this information when processing requests for additional time to make a section 754 election under section 1.9100-1(a) of the regulations.

When processing these requests, one of the foremost concerns is preventing taxpayers from using the relief provision in

section 1.9100-1(a) of the regulations to engage in retroactive tax planning. The taxpayer's response to Question R indicates whether the taxpayer knew of the transfer prompting the request. If the taxpayer knew of the transfer and knew of the availability of the election, then relief is not appropriate.

Furthermore, the question and the attendant instructions serve to educate the uninformed. Many attorneys and accountants are unaware of the election and the ramifications of a transfer of a partnership interest or a distribution described in section 734(b) of the Code. This concern seems particularly important with respect to the Form 1065EZ. That form is designed to be usable by small partnerships without professional help. Presumably, the partners in such partnerships are in even greater need of information concerning the election.

Fifth, we believe that questions P, J, K, & L should be retained. It may be that this information is used mostly during audits and is not necessary in the initial processing of returns, but audits are an important part of the Internal Revenue Service's function, and returns play a important role in audits. The returns constitute the Service's records on a particular taxpayer, and, as such, should provide the auditor with useful information, regardless of whether or not the information is used for other purposes, in much the same way the Office of Chief Counsel uses the taxpayer's response to Question R when processing requests for an extension of time to make an election under section 754.

Sixth, on the first page of the instructions, the first sentence of the third paragraph under the definition of partnership should be deleted. That sentence says that an expense sharing agreement is not a partnership. It is our view that the expense sharing agreement exception to the definition of a partnership is a very narrow one, particularly in light of the decision in Madison Gas & Electric Company v. Commissioner, 72 T.C. 521, 562 (1979), aff'd, 633 F.2d 512 (1980). In that case the Tax Court found a business activity or profit motive to exist where organizations band together to achieve economies of scale through a cost sharing arrangement. Such a business purpose is one of the primary distinctions between associations, taxable as partnership or corporations, and nontaxable trusts. See section 301.7701-4(b) of the regulations.

Because of the narrow application of the expense sharing arrangement exception, we fear that the prominent mention of it in the instructions to the Form 1065 might be misleading. Taxpayers involved in a true expense sharing arrangement would probably never think that the arrangement might be treated as a partnership. Those involved in organizations taxable as partnerships or corporations sometimes try to have their organizations classified as a type of organization with fewer

reporting requirements and greater flexibility--such as an expense sharing agreement.

Seventh, we believe that the material explaining the Passive Activity Loss rules should be retained in its current form rather than replacing it with a short explanation and a reference to the Service's publication on the rules. These rules are still sufficiently new and still engender sufficient confusion that the public needs as much explanatory material as possible. With time, it may become appropriate to adopt your suggestion concerning this material, but we do not believe that the time has come.

If you have any questions, please contact J. Scott Hargis at FTS 343-8459.